Taxation of Social Security Benefits Under U.S.-Canada Income Tax Treaty

Notice 98–23

This notice provides guidance, in a question and answer format, regarding recent changes to the taxation of cross-border social security benefits under the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980 as Amended by the Protocols Signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (the "Treaty"). For an overview of the changes, see Section I of this notice. For rules that apply to U.S. residents who receive Canadian social security benefits, see Section II. For rules that apply to Canadian residents who receive U.S. social security benefits, see Section III. For information concerning the Paperwork Reduction Act, see Section IV. For drafting information, see Section V.

I. OVERVIEW OF CHANGES

Paragraph 5 of Article XVIII of the Treaty provides rules that govern the taxation of U.S. social security benefits paid to Canadian residents and Canadian social security benefits paid to U.S. residents. These rules were extensively revised by the protocol signed on March 17, 1995 (the "1995 Protocol") and again by the protocol signed on July 29, 1997 (the "1997 Protocol").

Under the Treaty prior to amendment by the 1995 Protocol, each country had the exclusive right to tax social security benefits paid to its residents by the other country. The 1995 Protocol changed from a residence-based system to a source-based system, effective January 1, 1996. Under the 1995 Protocol, the country that paid benefits to residents of the other country had the exclusive right to tax the benefits.

The 1997 Protocol returned to a residence-based system under which social security benefits are taxable exclusively in the country where the recipient resides. The changes made by the 1997 Protocol are generally retroactive to January 1, 1996. However, benefits paid during 1996 and 1997 will not be subject to a higher rate of tax than was imposed under the 1995 Protocol. In addition, as explained below, individuals who received benefits during 1996 and 1997 that would be subject to a lower rate of tax under the 1997 Protocol may be eligible for refunds.

II. U.S. RESIDENTS WHO RECEIVE CANADIAN BENEFITS

WHICH CANADIAN BENEFITS ARE COVERED?

The changes made by the 1997 Protocol affect the taxation of Old Age Security (OAS) pensions and Canada/Quebec Pension Plan (CPP/QPP) benefits.

HOW WERE MY BENEFITS TAXED DURING 1996 AND 1997?

Under the old rules (that is, the 1995 Protocol), Canadian social security benefits paid to U.S. residents during 1996 and 1997 were subject to a 25-percent Canadian withholding tax. However, Canada permitted U.S. recipients of Canadian benefits to file Canadian tax returns and pay tax at regular graduated rates on their net income. As a result, some U.S. recipients of Canadian social security benefits may have paid little or no Canadian tax on their benefits.

HOW WILL MY BENEFITS BE TAXED UNDER THE NEW RULES?

Under the new rules (that is, the 1997 Protocol), Canadian social security benefits paid to U.S. residents generally will be taxable, if at all, only by the United States. The benefits will be taxed at graduated rates on a net basis as if they were benefits paid under the U.S. Social Security Act. Thus, under section 86 of the Internal Revenue Code, the portion of the benefits that is taxable will depend on each recipient's income level. For more information on the rules that apply to benefits paid under the U.S. Social Security Act, see IRS Publication 915 (Social Security Benefits and Equivalent Railroad Retirement Benefits).

WHEN DO THE NEW RULES TAKE EFFECT?

The new rules must be applied to benefits received during 1998 and future years. For 1996 and 1997, a U.S. resident who received Canadian social security benefits may choose to be taxed in the United States under the new rules or to remain taxable in Canada under the old rules.

WILL I HAVE TO PAY ANY ADDITIONAL TAX FOR 1996 OR 1997?

The United States and Canada have agreed that taxpayers' 1996 and 1997 benefits will not be subject to an increased rate of tax solely as a result of the 1997 Protocol. Therefore, U.S. recipients of Canadian social security benefits during 1996 or 1997 should not have to pay any additional tax unless there is some other factor that alters their tax liability.

AM I ENTITLED TO A REFUND OF CANADIAN TAX?

U.S. residents who received Canadian social security benefits during 1996 and 1997 on which Canadian tax was paid may be entitled to refunds. Taxpayers should calculate the amount of U.S. tax, if any, they would have been required to pay for 1996 and 1997 under the new rules. If this amount is less than the amount of Canadian tax paid, they generally are entitled to a refund of the Canadian tax. However, they will be required to report the benefits on U.S. returns (see below) and pay any U.S. tax that would be due.

WHAT SHOULD I DO TO OBTAIN MY REFUND?

During February 1998, Revenue Canada mailed letters to U.S. residents who received Canadian social security benefits during 1996 and 1997. Recipients of such letters should follow the instructions provided in the letter and submit the attached Election Form to Revenue Canada if they elect to be taxed in the United States. Revenue Canada will process the Election Forms and issue checks in the appropriate amount. Revenue Canada will notify the Internal Revenue Service of the Canadian benefits paid to the affected individuals and the amounts of the refunds issued.

Taxpayers who did not receive a letter, but believe they are entitled to a refund of

Canadian tax, should contact Revenue Canada by calling 1-800-661-7896, by sending a fax to 613-941-6905, or by writing to the International Tax Services Office, 2204 Walkley Road, Ottawa, Ontario K1A 1A8. Under the 1997 Protocol, taxpayers must apply for any refund of Canadian tax on or before December 16, 2000, which is three years from the date the 1997 Protocol entered into force.

CAN I REVOKE MY ELECTION TO BE TAXED IN THE UNITED STATES INSTEAD OF CANADA?

A taxpayer who receives a refund of Canadian tax may later determine that the amount of U.S. tax owed for 1996 and 1997 under the new rules is greater than the amount of Canadian tax that was originally paid. In this case, the taxpayer may contact Revenue Canada on or before December 16, 2000 to revoke the election and repay the Canadian tax. Revenue Canada will then advise the Internal Revenue Service that the taxpayer has revoked the election to be taxed in the United States.

HOW SHOULD I REPORT BENEFITS FOR 1996 AND 1997 ON MY TAX RETURNS?

Taxpayers who are not applying for refunds from Revenue Canada should not report the Canadian social security benefits received during 1996 and 1997 on U.S. federal income tax returns for 1996 and 1997. Taxpayers who are applying for refunds should report the benefits on U.S. returns as if the benefits had been paid under the U.S. Social Security Act. For more information on how to report benefits paid under the U.S. Social Security Act, see IRS Publication 915 (Social Security Benefits and Equivalent Railroad Retirement Benefits).

Taxpayers who apply for refunds and have not yet filed a 1996 or 1997 U.S. tax return must report the Canadian benefits on a 1996 or 1997 (as the case may be) U.S. tax return. Such a U.S. return must be filed even if a U.S. return would not otherwise be required and even if no U.S. tax is due. Taxpayers who were not previously required to file U.S. returns will be required to do so as a result of their election to be taxable in the United States. At the top of their return, taxpayers should print or type the caption "CANADIAN TREATY—SOCIAL SECURITY."

Taxpayers who have already filed returns for 1996 and 1997 should file amended returns after they have received their refund checks from Revenue Canada and pay any U.S. tax that may be due. Interest and penalties generally will not be imposed if the additional U.S. tax (if any) is paid by April 15, 1999. At the top of their amended return, taxpayers should print or type the caption "CANADIAN TREATY—SOCIAL SECURITY."

Taxpayers will not be entitled to any foreign tax credit for the Canadian tax that will be refunded.

HOW SHOULD I REPORT BENEFITS FOR 1998 AND FUTURE YEARS ON MY TAX RETURNS?

Canadian social security benefits received during 1998 and future years should be reported as if they were paid under the U.S. Social Security Act. For more information on how to report benefits paid under the U.S. Social Security Act, see IRS Publication 915 (Social Security Benefits and Equivalent Railroad Retirement Benefits).

III. CANADIAN RESIDENTS WHO RECEIVE U.S. BENEFITS

WHICH U.S. BENEFITS ARE COVERED?

The changes made by the 1997 Protocol affect the taxation of monthly benefits under title II of the Social Security Act and tier 1 railroad retirement benefits.

HOW WERE MY BENEFITS TAXED DURING 1996 AND 1997?

Under the old rules (that is, the 1995 Protocol), U.S. social security benefits paid to Canadian residents during 1996 and 1997 were subject to a 25.5-percent U.S. withholding tax. This was a final payment of tax. Canadian recipients of U.S. social security benefits, regardless of their level of income, could not elect to be taxed in the United States on a net basis at graduated rates.

HOW WILL MY BENEFITS BE TAXED UNDER THE NEW RULES?

Under the new rules (that is, the 1997 Protocol), U.S. social security benefits paid to Canadian residents generally will be taxable only by Canada. An amount equal to 85 percent of the benefits that are received will be subject to Canadian tax on a net basis as if the benefits were paid under the Canadian Pension Plan.

WHEN DO THE NEW RULES TAKE EFFECT?

The new rules must be applied to benefits received during 1998 and future years. For 1996 and 1997, Revenue Canada will determine whether it is more beneficial for taxpayers to be taxed in Canada under the new rules or to remain taxable in the United States under the old rules. More information is provided below.

WILL I HAVE TO PAY ANY ADDITIONAL TAX FOR 1996 OR 1997?

The United States and Canada have agreed that taxpayers' 1996 and 1997 benefits will not be subject to an increased rate of tax solely as a result of the 1997 Protocol. Therefore, Canadian recipients of U.S. social security benefits during 1996 or 1997 should not have to pay any additional tax unless there is some other factor that alters their tax liability.

AM I ENTITLED TO A REFUND OF U.S. TAX?

Canadian residents who received U.S. social security benefits during 1996 or 1997 on which U.S. tax was paid may be entitled to a refund. Revenue Canada will calculate the amount of Canadian tax, if any, that would have been due for 1996 and 1997 under the new rules. If this amount is less than the amount of U.S. tax paid, the taxpayer generally will be entitled to a refund of the excess amount. Revenue Canada will notify taxpayers who are entitled to refunds.

WHAT SHOULD I DO TO OBTAIN MY REFUND?

Taxpayers who believe they are entitled to a refund should not claim a refund from the Internal Revenue Service at this time. Revenue Canada has set up procedures for determining which Canadian residents are entitled to refunds. Revenue Canada will apply for and obtain the refunds from the Internal Revenue Service on behalf of the affected individuals and will issue checks to them as soon as possible in the appropriate amount.

IV. PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1602.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information in this notice are in Sections II and III. This information is required to implement the 1997 Protocol. This information will be used to determine the amounts of refunds of U.S. tax to which certain Canadian residents are entitled and to notify the Internal Revenue Service as to the amounts of refunds of Canadian tax paid to certain U.S. residents. The collections of information are mandatory. The likely respondents are individuals.

The estimated total annual reporting burden is 25,000 hours.

The estimated annual burden per respondent varies from .25 hours to 1 hour, depending on individual circumstances, with an estimated average of .5 hours. The estimated number of respondents is 50,000.

The estimated annual frequency of responses is one time.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

V. DRAFTING INFORMATION

The principal authors of this notice are M. Grace Fleeman of the Office of Associate Chief Counsel (International) and Margaret M. Gavaghan of the Office of the Assistant Commissioner (International). For further information regarding this notice, contact Ms. Gavaghan on (202) 874-1550 (not a toll-free call).